No. 12,750

United States Court of Appeals

For the Ninth Circuit

LUCILLE MCGAH, E. W. MCGAH, CAROLE O'SHEA AND JOHN P. O'SHEA,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONERS' OPENING BRIEF.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONERS' OPENING BRIEF.

THE JURISDICTION OF THIS COURT.

The petitioners are residents of the Northern District of California and duly filed their income tax returns for the calendar year 1944 with the Collector of Internal Revenue for the First District of California, all within the jurisdiction of this Court.

The Petition for Review by this Court was filed pursuant to Sections 1141 and 1142 of the Internal Revenue Code to review the decision entered by the Tax Court of the United States on July 31, 1950 (15 T.C. No. 11) determining deficiencies in the petitioners' respective income tax returns for the calendar year 1944 in the following amounts: Lucille McGah, $8,452.01; E. W. McGah, $8,452.00; Carole O'Shea, $2,337.28 and John P. O'Shea, $2,337.30 (Tr. p. 88).

SCOPE OF THE REVIEW BY THIS COURT.

Now that I.R.C. Sec. 1141 (a) has been amended (Sec. 36, Act of June 25, 1948, P.L. 773, 80th Cong. 2nd Sess. effective Sept. 1, 1948), the rule of the *Dobson* case (320 U.S. 489, Rhg. Den. 321 U.S. 231) has been abrogated. Under the law now in effect, this Court may review decisions of the Tax Court in the same manner and to the same extent as decisions of a District Court tried without a jury.

Rule 52 (a) of the Federal Rules of Civil Procedure, provides, *inter alia,* that, in all actions tried upon the facts without a jury, findings of fact shall not be set aside *unless clearly erroneous,* due regard being given to the opportunity of the trial court to judge the credibility of the witnesses.

A finding which *is* clearly erroneous *can* be set aside and *should* be set aside.

And errors of law should, of course, be corrected.

NATURE OF THE CONTROVERSY.

In 1944, San Leandro Homes, a partnership, of which Petitioners E. W. McGah and John P. O'Shea were partners, sold 14 of 95 homes which they built for rental to defense workers and which had been used in the partners' house rental business rented continuously since their completion to a total of 156 defense worker tenants prior to the sale of the first home, the sale having been made as the houses became vacant under pressure from the Bank from which the partnership sought to borrow more money.

The partners reported the gain from the sale of the 14 homes as a long term capital gain under the provisions of I.R.C. Sec. 117 (j).

The Respondent claims that the gain should have been reported as ordinary income.

The Tax Court made a finding of fact (claimed by Petitioners to be clearly erroneous) that just prior to the sale of the first of the 14 homes on August 1, 1944, the partners *"abandoned"* their purpose of holding the 95 homes primarily for rental and investment and that thereafter and at the time of sale were holding the homes primarily for sale to their customers in the ordinary course of their trade or business.

Sec. 117 (j) of the Internal Revenue Code provides, so far as material here, as follows:

> "(j) GAINS AND LOSSES FROM * * * THE SALE * * * OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS.—
>
> "(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term *'property used in the trade or business'* means * * * *real property* used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *.
>
> "(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, * * * exceed the recognized losses from such sales, * * * such

gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. * * *"

The Petitioners claim, as hereinafter shown, that the Tax Court's specified findings are *clearly erroneous* and contrary to the evidence and that it has misconstrued the meaning and legal effect of I.R.C. Sec. 117 (j).

STATEMENT OF THE CASE AND STATEMENT OF THE QUESTIONS INVOLVED.

The relevant facts, shown by the record, many of them *stipulated,* are as follows:

San Leandro Homes is a partnership formed August 31, 1942 by petitioners E. W. McGah and John P. O'Shea, (Stipulated) (Tr. 147) for the purpose of erecting 169 homes for defense workers in San Leandro, California (Stipulated) (Tr. 155). The partnership articles recite that it contemplated *rental* rather than the sale of these homes (Stipulated) (Tr. 154-155).

The partners held their respective interests in the partnership as community property with their respective wives, petitioners Lucille McGah and Carole O'Shea (Stipulated) (Tr. 147-148). In 1944, husband and wife each reported one-half of the partner's share of partnership income for Federal income tax purposes (Stipulated) (Tr. 148).

The partnership, in order to obtain materials for the 169 houses, applied to the Office of Production Management at San Francisco (Stipulated) (Tr. 160-164) for

priorities for 169 *rental* units, 100 to *rent* at $50.00 per month and 69 units to *rent* at $39.99 per month (Stipulated) (Tr. 163).

Delmar Goforth, an original associate of petitioners, withdrew from the venture when he learned that 169 *rental* units were to be built (Testimony) (Tr. 113).

The partnership sought allocations for 169 units scheduled to *rent* for $50.00 per month each (Testimony) (Tr. 117), but actually obtained 69 allocations for units to *rent* at $39.99 per month and 100 units scheduled to *rent* at $50.00 per month each (Stipulation) (Tr. 163).

The reason for the allocations for the 69 *rental units* to *rent* at $39.99 per month (instead of $50.00 per month) was because the Office of Production Management then had only 100 allocations for $50.00 per month rental units left (Testimony) (Tr. 116-117).

However, the partnership was told by Mr. Liggett, Assistant Chief Underwriter of the Federal Housing Administration, that more allocations for $50.00 per month *rental* units were expected and when they were available would be *substituted* for the 69 units scheduled to *rent* for $39.99 per month (Testimony) (Tr. 141-142-143; 116-117).

When the partners went back to the Federal Housing Administration about 6 months later, to effect the promised substitution, they were told that the expected allocation of more $50.00 *rental* units had not come through so that the partners would either have to stay by their $39.99 rental units, *or*, sell them (Testimony) (Tr. 118-119).

During the period between approximately September 12, 1943 and approximately February 1, 1943, the partnership constructed and completed the 169 dwelling houses (Stipulation) (Tr. 148).

All of the 169 houses built were identical in floor plan and in square footage content. The elevations were different (Testimony) (Tr. 114; 137-138). $4,000.00 was borrowed to provide the cost of each of the 169 lots and the houses erected thereon (Testimony) (Tr. 114-115).

All of the money for the construction of the 169 homes by the partnership was borrowed from Central Bank (Testimony) (Tr. 114-115). These loans were adequate for the cost of constructing the homes and paying for the lots upon which they were constructed (Testimony) (Tr. 114-115). *The loans were all 100% loans* (Testimony) (Tr. 115) (Stipulation) (Tr. 153).

The reason why the partnership did not want to rent units at $39.99 per month was that with a pay-back of around $33.00 per month plus maintenance at $6.00 or $7.00 per month, they would have had a *loss* on the 69 houses renting at $39.99, and *that is the only reason why they sold the 69 houses* (Testimony) (Tr. 118-119).

The partnership sold a total of 74 of the 169 houses before its rental operations began. The reason why 74 instead of only the 69 houses (scheduled to rent at $39.99) was that the sale of 74 houses left the partnership with a complete unit of 95 houses for rental, all on one side of a boundary street (Testimony) (Tr. 117).

These 74 houses sold included the 69 houses with rentals fixed at $39.99 per month. None of said 74 houses

so sold was ever rented by the partnership or used by it in connection with any rental operation prior to the sale thereof. The profit realized from the sale of said 74 houses was reported by said partnership as ordinary income (Stipulation) (Tr. 149) and is not involved here.

The partnership made its decision to sell these 74 houses about 3 or 4 weeks before the first of the 74 houses were sold which was after learning from Mr. Liggett of the Federal Housing Administration that there would be no substitutions of $50.00 rental units for the $39.99 rental units (Testimony) (Tr. 142-143).

74 of the 169 houses were sold without ever being rented. The remainder of said 169 houses, viz., 95 houses were rented by said partnership from and after on or about March 15, 1943 to persons engaged in National Defense activities. *From March 15, 1943 until August 1, 1944, said 95 houses were rented to 156 different tenants* (Stipulation) (Tr. 150).

The partnership would have kept the whole 169 houses and would not have sold any if it could have gotten all to rent at $50.00 per month each (Testimony) (Tr. 125).

The partners, in retaining and renting these 95 houses, *intended to hold them for rental and investment* (Testimony) (Tr. 124; 128-129). They rented the 95 units because it was a good investment (Testimony) (Tr. 125).

The partnership contemplated a rental venture from the very beginning—at the time of applying for the priorities (Testimony) (Tr. 129-130). The sale of the houses was not then contemplated (Testimony) (Tr. 140).

At the time the partnership accepted the allocation of priorities for the 69 units to *rent* at $39.99 it could have gotten allocations for houses for *sale, if it cared to* (Testimony) (Tr. 144).

At the time the partnership made its application for preference ratings on materials, *it was the full intention of the partners to embark on a rental project,* because it looked as if it would be a very advantageous one to the partners financially, inasmuch as they could secure 100% loans from the bank through F.H.A. insurance and by so doing they could receive 100% on no investment at all (Testimony) (Tr. 129).

The rental of said 95 houses was carried on by the partnership from an office which the partnership maintained for that purpose located at No. 1411 Davis Street, San Leandro, California. The houses were let on oral month-to-month tenancies at $50.00 per month. A commission of $10.00 per house was paid to an agent for renting. The rental operations were conducted by a lady employed for that purpose at the partnership's aforesaid office. She looked after all rental matters, including any complaints, collections and the like (Stipulation) (Tr. 150). Annexed to the stipulation and marked EXHIBIT "3", is a detailed statement of the receipts and disbursements of said partnership from said rental operations as shown by the partnership books, for the fiscal years of the partnership *commencing* October 31, 1943 and *ending* on the 31st day of October, 1949 (Stipulation) (Tr. 167):

These *stipulated* figures are both interesting and important. They show:

(a) that during the fiscal years 1943 to 1949, both inclusive, the partnership collected gross rentals in the sum of $212,166.01 from these rental units;

(b) that during these *seven years* they derived a *net rental income* of $12,171.00 from these houses and, in addition, *retained as tax free dollars,* on account of depreciation a total of $73,774.14 and in addition, provided for F.H.A. trust funds out of gross rentals in the total sum of $33,047.48, after paying all other expenses.

It will be borne in mind that it is also *stipulated* that these houses were built with 100% F.H.A. loans (Tr. 152-153) and that the partners originally *contributed* $13,500.00 in cash to the venture and that between December 1942 and August 1943 *withdrew* $88,725.00 therefrom (Tr. 153-4).

There was thus a *net rental income* in the 7 years of $12,171.00 on an investment of $13,500.00 which was the good investment that the partners testified to.

The stipulated facts show that in 1948 and 1949, when the partnership was still renting 35 houses, the depreciation allowance for each year was the same,—$7,041.34 (Tr. 167, last two columns).

Dividing $7,041.34 by 35 houses gives annual depreciation per house of $201.80. *Thus in 20 years, the tax free depreciation deductions alone would pay off each of said $4,000.00 loans on each house and lot* (Tr. 114-115).

About the middle of 1944, the partners discussed with the lending officer of Central Bank of Oakland, California, which bank the partnership was dealing with, the possibility of the partnership securing more loans under Title

VI of the National Housing Act. After their banker had reviewed their affairs he reported to the partners that the loan committee of the bank had observed that the partnership was already indebted for Title VI loans with respect to the said houses which the partnership was renting, in a sum in excess of $350,000.00, and he suggested to the partnership the advisability of their liquidating *some* of their rental properties in order to reduce their bank liabilities and as a means of providing themselves with additional working capital, suggesting in addition that they should take advantage of the then existing market for houses (Stipulation) (Tr. 153-154).

Petitioner McGah had his attention called to the stipulated facts in the preceding paragraph and was asked:

> "After that suggestion was made to you by the banker, Mr. McGah, *what did the partnership do* with respect to the advice so given?
>
> "A. Well, *as the houses became vacant*—in those days you didn't have to offer anything for sale. There was about 15 or 20 people available. The minute a van would move up, somebody would want the house, so *we disposed of them as they became vacant.*
>
> "Q. And you sold the 14 houses that were sold in the calendar year of the partnership that ended October 31, 1944, is that correct?
>
> * * *
>
> "A. Yes." (Tr. 116).

The petitioner O'Shea, asked the same question, answered (Tr. 127):

> "A. We sold 14 houses or *we disposed of such of those houses as they became vacant from time to time* * * *."

The record does not contain any direct evidence as to what the petitioners *intended* with reference to their purpose to hold houses for rental and investment when subjected to the pressure of the Bank's demand that they sell *some* of the rental houses other than evidence of what petitioners *did.* There is no direct evidence of any intent by them to abandon their purpose of holding the 95 units primarily for rental income and at most there is but an *inference* that they decided to sell some of their rental houses when houses became vacant.

The Bank's "advice" to sell was more than a suggestion. *It was more or less of a demand* (Testimony) (Tr. 127).

It will be noted that the 14 houses sold in 1944 by the partnership were sold *as they became vacant* (Supra).

No "for sale" signs were displayed on any of these 14 houses prior to sale and the homes were not advertised for sale (Testimony) (Tr. 121).

In 1944, during the period that the partnership was *renting* the 95 homes, *there was a very active market for homes. The partnership could have sold a hundred houses that year if it had tried. You could then sell 50 houses for every one you had* (Testimony) (Tr. 121-122). The market was "terrific" (Testimony) (Tr. 122).

During its fiscal year ended October 31, 1944, the partnership sold 14 of the 95 rented houses *as they became vacant* and *at the end of said fiscal year was still renting 81 thereof;* during its fiscal year ended October 31, 1945, said partnership sold 31 of said 81 houses and *at the end*

of said fiscal year was still renting 50 of said houses; during its fiscal year ended October 31, 1946, said partnership sold 13 of said 50 houses plus one additional home purchased and rented during the year and *at the end of said fiscal year was still renting 38 of said houses;* and during its fiscal year ended October 31, 1947, said partnership sold 3 of said 38 houses and *at the end of its fiscal years 1948 and 1949 held, and, at the time of the trial, still held and rented 35 of said original 95 houses* (Stipulation) (Tr. 150-151).

The first of these 14 houses sold in 1944 was sold on August 1, 1944, (EXHIBIT "4"—Schedule of GAINS ON SALES OF CAPITAL ASSETS) (Tr. 177).

Each of the 95 houses, sold as aforesaid, until it was sold, had been rented continuously by the partnership from on or about the time the construction of said house was completed (Stipulation) (Tr. 151).

The sale dates of the 14 houses sold in the fiscal year 1944 (See Tr. p. 177) are as follows: August 1, 1944; August 7, 1944; August 14, 1944; August 20, 1944; September 1, 1944; September 16, 1944; October 6, 1944; October 9, 1944; October 18, 1944.

Each of said 95 rented dwelling houses sold by said partnership, subsequent to April 1, 1943, was owned and held by said partnership for at least six (6) months prior to the sale thereof and prior to such sale and during the six months' period and at the time of its sale had been rented continuously by the partnership, as aforesaid (Stipulation) (Tr. 151).

The gain from the sale of the 14 houses sold in 1944 was reported as a long term capital gain pursuant to Internal Revenue Code Section 117 (j) (Tr. 175; Tr. 177).

We wish here to emphasize the *facts* (1) that the record is devoid of any *direct* testimony or proof of any intention on the part of petitioners to *abandon* their primary purpose of holding the 95 houses for rental and investment, the only proof being that *as houses became vacant,* they sold *some* of them; (2) that the rental venture continued *during the seven years,* 1943-1949, *both inclusive and was continuing at the time of trial with 35 of the original units* and (3) that it is a *stipulated fact* in this case that *each of the 95 houses sold, until it was sold, had been rented continuously from the time of its completion* (Tr. 151).

There was nothing in the priorities granted to the partnership for the 169 rental homes which prohibited their sale. EXHIBIT "2", which is the APPLICATION FOR PREFERENCE RATING, etc., par. 7 at page 4 (Stipulated) (Tr. 163) thereof under the caption GENERAL contains the following agreement:

> "* * *(b) I will not sell, nor will I lease or permit the sub-leasing of any dwelling unit *for more than the amount shown* in the Schedules under Item 4 or Item 5 above without the prior approval of the Director of Priorities, Office of Production Management, Washington, D. C. * * *"

This was an agreement relating to sale or rental *price,* but not a prohibition against sale.

The partnership could have sold all of the 169 houses had it wanted to (Testimony) (Tr. 125).

The partnership found out that it could sell all of the houses when it went back to the Federal Housing Authority after applying for the priorities. When they went back to get the substitution of $50.00 rental units for $39.99 units they found that it could sell all of the 169 units (Testimony) (Tr. 125).

Petitioners E. W. McGah and John P. O'Shea had, for a number of years, prior to 1944 been engaged in a number of business enterprises as shown by their income tax returns (Tr. 174-185), including the building, for sale of speculative homes (Stipulation) (Tr. 158).

During 1944, petitioners E. W. McGah and John P. O'Shea were also engaged in other businesses: Brennan, McGah & O'Shea, a joint venture which constructed and sold 121 homes (Tr. 160-164); Superior Tile Co., a copartnership in which they were equal partners, selling tile, linoleum, carpets and floor coverings of all kinds; Superior Tile and Linoleum Co. (Vallejo) a partnership engaged in the same business as Superior Tile Co.; Huston's Carpets and Linoleum (Oakland) a partnership selling appliances, furnishings, drapes, covers and general household covers; Towers & Marsh, a partnership, building homes (Testimony) (Tr. 119-120-121).

In its opinion, holding that the gain from the sale of these 14 rental houses sold in 1944 was taxable as ordinary income and was not taxable as a capital gain under Section 117 (j) of the Internal Revenue Code, the Tax

Court determined, contrary to the evidence, that "shortly before August 1, 1944, McGah and O'Shea decided that San Leandro Homes Co. should sell houses in order to get capital for further construction operations *and they 'abandoned' the purpose of holding the houses for the production of rental income*" and that "the business of San Leandro from before August 1, 1944 to the end of its fiscal year ended on October 31, 1944 was the sale of houses. At the time the houses were sold during the fiscal year ended on October 31, 1944, the houses were held primarily for sale to customers in the ordinary course of trade or business and they were *not* held primarily for investment purposes". (Tr. 72).

As a result of the foregoing, the Tax Court determined deficiencies for the year 1944 for the respective petitioners as follows:

E. W. McGah	$8,452.01
Lucille McGah	8,452.01
John P. O'Shea	2,337.30
Carole O'Shea	2,337.28

SUMMARY OF THE CRITICAL FACTS.

The following is a succinct summary of the *critical facts* set forth in the foregoing statement of facts that are determinative of the Tax Court's errors:

The *overwhelming proof* that the *95 houses in question were being used in the partnership's house rental business until the very moment of sale* and that the partnership *had never "abandoned"* its *purpose to hold the 95 houses primarily* for rental investment is that:

(a) The partnership was *formed* for the purpose of building 169 *rental* homes;

(b) An original associate, Goforth, withdrew from the venture *because* it was a *rental* deal;

(c) 74 houses were sold (including the 69 $39.99 rental units) *only* because they could not be rented at a profit, when it was found that the promised substitution of $50.00 rental units for the $39.99 rental units did not materialize;

(d) Despite the fact that the partnership *could* have sold the remaining 95 units, had they wanted to, they clung to their purpose and *rented* them;

(e) The sale of *rental* houses resulted from *pressure,* viz.—the bank's "suggestion" (virtually a demand) that they sell *some* (note that it was "some" and not "all") of the rental houses;

(f) The only evidence in the record of what the partnership *intended* as a result of what the bank "suggested" is what the partnership *did* and what they *did* in 1944 was to sell *some* (14) of the houses *as they became vacant;*

(g) The only correct inference of their *intention* is that they intended to sell *some* of the rental units as they become vacant;

(h) It is a *stipulated fact* that each house was *rented* from the time of its completion until the time it was sold, so that the *first* house sold had been rented continuously for over 17 months until it was sold;

(i) The purpose of the partnership to *adhere to its purpose of* holding the houses *primarily* for rental is proven conclusively by the *stipulated facts* that at the end of the six following fiscal years and even on

the date of trial they were *still holding substantial numbers of houses for rental.* Thus

End of fiscal year	Number of rental houses held
1944	81
1945	50
1946	38
1947	35
1948	35
1949	35
Date of trial	35

(j) The record shows conclusively and the Tax Court found that the market for houses during 1944 was *very active* and that they *could be sold without advertising* and the uncontradicted testimony is that the market was *"terrific"* and that *you could have sold 50 for every one you had;*

(k) In the face of this market the partnership continued for 17 months to *rent* houses when it could easily have sold them and then sold only 14 in 1944 when, had it desired, it could easily have sold *all*;

(l) The *stipulated facts* show that the *depreciation* on each house was $201.18 per year; that the partnership borrowed on 100% FHA loans $4,000.00 to cover the cost of each house and lot; that therefore, on 100% FHA loans with an investment of zero dollars the partnership in 20 years could have paid off each $4,000.00 loan (20 x $201.18 = $4,023.60) *out of tax free depreciation dollars alone.*

(m) The most that the evidence can be claimed to show is that the partners *intended to sell some* (not "all") *of the rental houses as they became vacant* and there is *no evidence* that they intended to *"abandon"* their *purpose* of holding the houses for rental investment.

These are the *proven facts* and when the Tax Court's findings and opinion are read against the background of the *facts* it will be seen that the Tax Court has substituted *conjecture* for *fact* and has *assumed* an intention to *"abandon"* the rental purpose when no such intention was proven and has indulged in an *inference* of "abandonment" contrary to law.

One needs only to read *seven recent Tax Court decisions,* and one Circuit Court decision, *each dealing with numerous sales of property used in trade or business where the gains were held to be subject to the limitations of IRC Sec. 117 (j)* to see the obvious error of the Tax Court's findings and decision.

The basic findings are *clearly erroneous* and the Court's conclusions are *contrary to law.*

SPECIFICATION OF ERRORS.

Petitioners specify the following errors:

I.

The Tax Court erred in finding that petitioners McGah and O'Shea "abandoned" the purpose of holding the houses primarily for the production of rental income.

II.

The Tax Court erred in finding that "the business of San Leandro from before August 1, 1944, to the end of its fiscal year was the sale of houses" and that "at the time the houses were sold during the fiscal year ended on October 1st, 1944, the houses were held

primarily for sale to customers in the ordinary course of trade or business and they were not held primarily for rental-investment purposes."

III.

The Tax Court erroneously construed Sec. 117 (j) of the Internal Revenue Code as meaning that there could be no *primary* purpose of holding property for rental investment purposes if there was a *secondary* purpose of selling the homes, if and when, at some future time, that might be advisable or desirable.

IV.

The Tax Court erroneously concluded that "The Central Bank was not disposed to carry San Leandro for any extended period of time, according to the record before us", whereas the Tax Court's very own finding that the Bank's requirement for faster liquidation related to additional borrowing, rather than to the borrowing related to the 95 rental homes which the Tax Court found were financed as 100% F.H.A. loans, none of which were shown to be in default.

V.

The Tax Court erroneously construes Section 117 (j) of the Internal Revenue Code, in its reference to the use of property in the trade or business of a taxpayer, as being inapplicable unless the taxpayer's purpose is to hold the property for trade or business or investment purposes *"for a long period of time."*

VI.

The Tax Court erroneously holds that where capital is required for a project there is a lack of a primary

purpose to invest capital and hold property to produce income for investment purposes where the taxpayer, either lacks substantial capital of his own or uses relatively small amounts of his own capital and borrows practically all of the capital for the purpose of its project, thus overlooking the fact, as it found in its findings of fact, that 100% F.H.A. insured loans were available for and used in this very rental project.

VII.

The Tax Court in its decision in the instant case has arrived at a conclusion with respect to the legal effect and meaning of Section 117 (j) of the Internal Revenue Code that is contrary to its determination as to its meaning and effect as determined by it in six (6) other recent decisions involving the application of Section 117 (j) to cases involving the sale of rental units.

VIII.

The Tax Court misapplied the provisions of Section 117 (j) of the Internal Revenue Code to the case at bar in that the Tax Court's very finding that taxpayers *"abandoned"* their primary purpose of holding the 95 houses primarily for the production in their rental business *proves the existence of their primary purpose to hold the 95 houses for investment and the production of rental income, as specified in Section 117 (j) IRC,* which is corroborated by the fact that the 95 houses *were used in the rental business until the very moment of their sale* and thus refused to apply Section 117 (j) to a case wherein the taxpayers sold real property held by them for over six months and held at the time of sale in their rental

business, primarily for the production of rental income and not held primarily for the sale to customers in the ordinary course of trade or business.

IX.

The Tax Court erred in failing and refusing to allow to be taxed under the provisions of Section 117 (j) IRC, the gain resulting from the sale by the taxpayers of real property, used by them in and held primarily by them for the production of income in their trade or business of renting dwelling houses, which houses they had owned and held for over six months at the time of sale and which houses were not held primarily for sale to customers in the ordinary course of trade or business.

In presenting the argument in support of the above specifications of error, the same, for convenience and brevity, will be presented under the headings that follow.

Unless otherwise indicated, all emphasis in this Brief is by counsel.

ARGUMENT.

I.

THE TAX COURT'S FINDING THAT THE PARTNERS "ABANDONED" THEIR PURPOSE OF HOLDING THE 95 HOUSES PRIMARILY FOR THE PURPOSE OF PRODUCING RENTAL INCOME IS CLEARLY ERRONEOUS FIRST, BECAUSE IT IS CONTRARY TO THE EVIDENCE AND SECOND, BECAUSE IT IS A FINDING MADE CONTRARY TO LAW.

The Tax Court has made the following finding of fact:

"Shortly before August 1, 1944, McGah and O'Shea *decided that San Leandro should sell houses* in order

to obtain capital for further construction operations and they *abandoned* the *purpose* of holding the houses primarily for the production of rental income. They decided to sell houses as tenants occupying them under oral month to month tenancies vacated them. The business of San Leandro from before August 1, 1944 to the end of its fiscal year was the sale of houses. At the time houses were sold during the fiscal year ended on October 31, 1944, the houses were held primarily for sale to customers in the ordinary course of trade or business and they were not held primarily for investment purposes'' (Tr. 72).

1. **The Tax Court has confused an inference of a decision by the partners to sell some of their rental units with an inference of an intention to abandon their purpose of holding the 95 homes for rental and investment purposes.**

We have shown that there is *no direct evidence* in the record of an *intention* on the part of the partners to *abandon* their purpose of holding the 95 homes primarily for rental income purposes.

The *stipulated facts* show the *pressure* exerted by the bank,—that they sell *some* (NOT ALL) of their rental units to provide themselves with more working capital and in order to take advantage of the existing market for the sale of homes (Tr. 153).

They were *not* required by the bank to sell *all* of the units and have *never sold all.* They still rent 35 of the units.

The record tells us what the partners *did* in response to the bank's pressure and from these facts, the Tax Court, in making its finding, *has drawn an inference.*

It is well established that an inference must be founded on fact and must be the probable and natural explanation of the fact. In 20 *Am. Jur.* p. 163, Sec. 159, it is said that "a fact can be regarded as the basis of an inference *only* where the inference is a *probable* or *natural* explanation of the fact. * * *"

The very finding by the Tax Court that just prior to August 1, 1944 the partners *"abandoned"* their primary rental purpose *necessarily admits* that until then the partners must have *had* that purpose. *They surely could not have "abandoned" a purpose which they did not have.*

The very most that can be inferred from the conduct of the partners is that in response to pressure from the bank, *they decided to sell some of their 95 rental units as they became vacant.*

What the Tax Court has done has been to *draw an erroneous inference from the facts.*

It has confused a *decision* by the partners to sell *some* of their rental units with a decision to *abandon* their purpose of holding the houses (i.e.—*the 95 rental units)* primarily for the production of rental income.

Not only did the Tax Court draw an *erroneous* inference but it also drew one that, *in law,* it was not justified in drawing.

No doubt but that the rental houses sold ceased, after their sale, to be used in the rental project. But there is no proof of an intent by the partners to *abandon* their primary *purpose* of holding the 95 houses for rental investment.

They simply sold some of the houses that they were holding for that purpose, but they did not abandon their purpose so that it can be said that the purpose *ceased to exist with respect to all 95 houses just prior to August 1, 1944.*

2. The Tax Court's finding that the partners "abandoned" their primary rental purpose is contrary to law.

"Abandonment" is no half-way or conditional thing. Thus, in 1 *Cal. Jur.* p. 8, Sec. 6, it is pointed out that there can be no such thing as a "conditional" abandonment. *"It must be all in all or not at all." Travaskis v. Peard,* 111 Cal. 599.

There is something *absolute, final* and *utterly irrevocable* about an abandonment. The New Century Dictionary says that "abandon" means to "yield or relinquish *utterly.*"

In *In Re Edwards,* 117 Cal. App. 667, at page 672, the Court says:

> "* * * The word *'abandon',* as defined by Webster, means 'To relinquish or give up with the intent of *never again* resuming or claiming one's rights or interests in; to give up *absolutely;* to forsake *entirely;* to renounce *utterly;* to relinquish *all connection* with or concern in; to desert, as a person to whom one is bound by a special relation of allegiance or fidelity; to quit; to forsake' (Webster's New International Dictionary.) * * *"

Again, in 1 *C.J.S.,* page 3, the term "abandon" is thus defined:

> "To abdicate, desert, forsake, give up, resign, surrender or yield *entirely without intention to reclaim,*

repossess or return; *totally* to withdraw from an object; to lay aside *all* care for it; to leave it *altogether* to itself; also to remove."

In Re Cordy, 169 Cal. 150, at 153 repeats Webster's definition of "abandon" which is found in *In Re Edwards,* supra.

The element of "*irrevocability* and *finality* in an abandonment is made clear in the decision in *Del Giorgio v. Powers,* 27 Cal. App. 2d 668 and 682 where the Court quotes from *Richardson v. McNulty,* 24 Cal. 339, 345, as follows:

> "* * * By the act of occupancy, the plaintiff made it his, and manifested his intention to do so. Once his, it continues his until he manifests his intention to part with it in some manner known to the law. He may sell it or give it to another, or transfer it in any other mode authorized by law, (thereby preserving the continuity of possession), or he may *abandon* it. In doing the latter he must leave it *free to the occupation of the next comer,* whoever he may be, *without any intention to repossess or reclaim it* for himself in any event, and *regardless* and *indifferent* as to what may become of it in the future. * * *"

Everhart v. State Life Ins. Co (CCA 6) 154 F. 2d 347, 356, citing *State Mut. Life Ins. Co. v. Heine* (CCA 6) 142 F. (2d) 741, hold that the term "abandonment" means the *absolute* relinquishment or renunciation of a right.

Surely, it must be conceded that the record *lacks any affirmative proof of an intention to abandon their purpose* with respect to the 95 rented homes, in the light of the legal meaning of that term.

The law is well settled that proof of *abandonment* must be *clear, unequivocal* and *decisive.* In 1 *Am. Jur.* p. 12, Sec. 17, it is said that,

> "* * * The burden is on him who sets up abandonment to prove same by *clear, unequivocal and decisive* evidence. * * *"

To the same effect: *In re Stilwell,* 120 F. 2d 194; *Hoff v. Girdler Corp.* (Colo.) 88 P. 2d 100; *Perry v. Reynolds* (Ida.) 122 P. 2d, 508; *Witt v. Poole,* 188 S. E. 496; *Stephens v. Stephens* (Tenn.) 185 S.W. 2d 915; *Alberti v. Jubb,* 204 Cal. 325; *Latham v. Los Angeles,* 87 Cal. 514; *McDonald v. Bear River, etc. Min. Co.,* 13 Cal. 220; *Hewitt v. Story,* 64 Fed. 510.

It is quite evident that the requisite degree of proof of abandonment is absent. There is no clear, *unequivocal* or *decisive* proof of an intention to abandon *their primary purpose.*

3. The Tax Court's inference of abandonment was contrary to law because the facts proven did not reasonably require an exclusive inference of abandonment.

Where it is sought to sustain an *inference* of abandonment, from the *facts proven,* they must be facts *from which no other inference can reasonably arise.*

In 1 *C.J.S.* page 15, Sec. 7 (c) it is said:

> "Abandonment must be *clearly proved* by competent evidence either of affirmative and conclusive acts, or of facts FROM WHICH NO OTHER INFERENCE CAN REASONABLY ARISE than that of relinquishment with intention to abandon."

In *Foulke v. N. Y. Consol. R. Co.,* 228 N.Y. 269, 127 N.E. 237, 238, it is said on the subject of "abandonment" as related to packages left on a train:

> "The evidence did *not* permit the jury to find that the package was *abandoned*. The *abandonment* of property is the relinquishing of *all* title, possession or claim to or of it—*a virtual throwing away of it*. It is not presumed. Proof supporting it must be direct or affirmative, or REASONABLY BEGET THE EXCLUSIVE INFERENCE OF THE THROWING AWAY. * * *"

Again, in *Columbus & G. Ry. Co. v. Dunn,* (Miss.) 185 So. 583, 586, the Court quotes with approval the following statement in 1 *Am. Jur.* p. 8, Sec. 11:

> "* * * In determining claims of abandonment the courts have generally announced that each case must depend mainly on its own particular circumstances, *the evidence of which must be full and clear.* Proof of abandonment *must be direct or affirmative,* or must reasonably beget *the EXCLUSIVE INFERENCE of intentional relinquishment of the property right involved.*"

The evidence in this record does not beget the *exclusive inference* of an intent by the partners to abandon their purpose of holding the 95 homes for rental investment.

At *most,* the evidence supports only a decision by the partners to sell *some* of the homes that they held for the *primary* purpose of producing rental income.

This latter and correct *inference* is thus *another* inference that *could* and *should* be drawn from the facts. The inference drawn by the Tax Court was not an inference which was the *only* one that could be drawn from the facts proved.

4. The inference of abandonment of purpose is contrary to the facts proven.

As opposed to its wholly unjustified *inference* that the partners abandoned their *purpose* of holding the 95 houses primarily for rental and investment and were holding them primarily for sale to customers etc. we have the *stipulated facts* which are contrary to the inference.

It is *stipulated* (Tr. 151) that each of the 95 houses sold, *until it was sold, had been rented continuously by the partnership from the time its construction was completed.*

It is *stipulated* that the rental project was continuing at the end of each of the fiscal years 1944, 1945, 1946, 1947, 1948 and 1949 with the following number of the original 95 houses still being rented (Tr. 150-151):

Fiscal Year Ended	Number of Houses Still Rented
1944	81
1945	50
1946	38
1947	35
1948	35
1949	35

Yet, the Court found that the purpose of holding the houses primarily for rental was *abandoned* just before the first house was sold on August 1, 1944.

Bearing in mind that the evidence shows without contradiction that in 1944 (*when only 14 houses were sold*) the market for houses was *"terrific"*, that you could sell 50 houses for every one you had (Tr. 121-122) that the Tax Court found (Tr. 70-71) that it was not necessary to advertise houses for sale, it is at once evident that had

the partners actually intended to *abandon* their rental *purpose,* they could have quickly and easily sold *all* the houses.

In the light of the undisputed evidence, the fact that they sold only 14, *as they became vacant* proves conclusively, we respectfully submit,

> *First,* that they resolved to *continue* with their rental-investment purpose with all the houses, making sales *only* of some of the houses, as houses became vacant; and
>
> *Second,* that they *did not* abandon their *purpose,* because if they *had* abandoned it, they could have sold *all* the houses very quickly and certainly would not have continued to this very day, still renting 35 of the houses.

The Tax Court found that following the Bank's "suggestion" (which was tantamount to a *demand*) that the partners sell "some" of the rental houses that (Tr. 70)

> "* * * McGah and O'Shea *then decided that San Leandro should sell houses.* * * *"

But it *did* not and *could* not find under the evidence that they decided to sell *all.*

But it does not follow that they decided to *abandon* their *purpose* of holding houses primarily for rental investment because, in bowing to the Bank's demand, they sold some of the houses as they became vacant.

Continuously holding houses for rental during the years 1944, 1945, 1946, 1947, 1948, 1949 and even on the day of trial, in the face of a market for houses which was "terrific",—where houses could be sold without advertis-

ing,—where you could "sell 50 houses for every one you had",—where it was more profitable to sell than to rent,—withholding sales until houses became vacant, etc.—are a compelling set of circumstances *absolutely inconsistent with the notion that just prior to August 1, 1944 the partners "abandoned"* their primary purpose of *holding the 95 houses for rental-investment.*

Quite naturally, *if they had abandoned* their purpose, one would have expected a prompt sale in order to take advantage of the market, instead of 14 sales in 1944, 30 in 1945, 12 in 1946, 3 in 1947 and none in 1948 or 1949.

The fact that they held on to them with the partnership renting 81 at the end of its 1944 fiscal year, 50 at the end of its 1945 fiscal year, 38 at the end of its 1946 fiscal year and 35 at the end of its 1947, 1948 and 1949 fiscal years and at the time of trial, and that every house sold was rented from the date of its completion, about March 15, 1943, until the very moment of sale—a *minimum* period of 17 months, most *strongly and emphatically corroborates the continuing purpose to hold them for rental-investment until they became vacant.*

II.

THE TAX COURT RESORTED TO IMPROPER LEGAL CRITERIA IN CONCLUDING THAT THE PARTNERS ABANDONED THEIR RENTAL PURPOSE AND THAT FROM AUGUST 1, 1944 TO THE END OF THE FISCAL YEAR ON OCTOBER 31, 1944, THE PARTNERS WERE HOLDING THE HOUSES PRIMARILY FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF THEIR BUSINESS.

1. **It is thoroughly well established as a matter of law that it is immaterial, so far as the application of Section 117 (j) is concerned that the partners were also engaged in selling houses.**

In its opinion (Tr. 82) the Tax Court says:

> "* * * It appears in these proceedings that the business of San Leandro was building houses, that *sales* thereof were *part* of that business and that it was *only by selling houses that San Leandro could turn over its capital* and build more houses. * * *"

This statement overlooks a principle now well settled as a matter of tax law: The fact that a taxpayer may be in the business of *selling* property and *also* in the business of *renting* the same kind of property does not prevent him from taking advantage of IRC Sec. 117 (j) when he sells his *rental* properties:

(a) *Elgin Bldg. Corp.*, 8 T.C.M. 114, (Feb. 15, 1949) where the taxpayers sold both *rental* and *non-rental* units. They were held entitled to capital gain limitations on the sale of the *rental* units, but not on the sale of the *non-rental* units. With respect to the latter, the Court said (p. 123):

> "* * * With respect, however, to the properties that were *sold without ever having been rented* and mostly within brief periods after completion, *we conclude*

> *that they were held,* and, in fact produced, *primarily* for sale and that the gain on their disposition was ordinary income. Their number, frequency and regularity require that conclusion. *Spanish Trail Land Co.,* 10 T.C. 430. * * *"

In our instant case, the taxpayers sold 74 units which they never rented and held and rented 95 units.

(b) Again in *Julia K. Robertson,* 8 T.C.M. 870 (Sept. 29, 1949) where the taxpayer was afforded relief under Sec. 117 (j) with respect to the sale of his *rental* units, the Commissioner argued that the taxpayer derived a larger percentage of profits from sales than from rentals, that petitioner was *involuntarily* in the rental business, that his subsequent resumption of building for sale indicates that in the taxable years he was holding the property for sale. With all this the Tax Court disagreed, holding that it was *immaterial* whether taxpayer was in the rental business from *necessity* or *choice*:

> "* * * Many individuals in the war years changed the kind of business in which they were engaged. *In some instances the ratio of profits was larger and in others smaller, but as patriotic citizens they cooperated regardless of results.* A vast majority of them, when the war ended, resumed the same business in which they had theretofore been engaged, as did petitioner."

Here again, *despite his sales business,* the taxpayer enjoyed the benefit of Sec. 117 (j), on the sale of *rental* units.

(c) *Claude M. Ferguson* (decided March 21, 1950) 9 T.C.M. 243, where the taxpayer sold both *rental* and *non-*

rental property and was allowed the benefit of Sec. 117 (j) on the sale of the *rental* units.

(d) *Nelson A. Farry* (decided July 6, 1949) 13 T.C. 8, where the taxpayer sold both *rental and non-rental* units and had relief under Sec. 117 (j) with respect to the sale of *rental* units.

(e) *A. Benetti Novelty Co.,* (decided December 22, 1949) 13 T.C. 1072 where the taxpayer was in the business of selling *non*-rental units as well as in the *rental* business and had relief with respect to the gain on the sale of *rental* units under Sec. 117 (j) after having decided to sell all of the older units and to retain only the newer units in its rental business.

(f) Note that in *E. Everett Van Tuyl,* 12 T.C. 900, 905, it is said that,

> "It is established that a taxpayer may be a *dealer* as to *some* securities and *he may also hold similar* or other *securities on his own account for purposes other than for resale to customers.* As to the latter, he is not a dealer, he is not entitled to compute income on the inventory method and securities so purchased are properly recognizable as capital assets within the meaning of Sec. 117 (a) (1)" (Citing cases).

(g) See *Mary A. Browning et al.,* decided by the Tax Court November 27, 1950, 9 T.C.M. 1061. The Tax Court said the 56 items sold during the taxable years 1944 and 1945 had been rented a total of 218 times. (In our instant case, the 95 houses were rented to 156 tenants before the first house was sold.) The Tax Court then said:

> "The fact that these 56 pieces of equipment were eventually sold after much service does not militate against our conclusion that they were held *primarily* for *rental* purposes. *Nor does the fact that the partnership was also in the business of selling such equipment and that its gross sales exceeded its rental income during the years here involved.* As said in *Nelson A. Farry,* 13 T.C. 8, 'A DEALER CAN ALSO BE AN INVESTOR'. See also, *A. Benetti Novelty Co. Inc.,* 13 T.C. 1072; *Carl Marks & Co.,* 12 T.C. 1196; *E. Everett Van Tuyl,* 12 T.C. 900."

(h) *Delsing v. U.S.* (CC 5) (not yet officially reported) decided January 5, 1951. There the taxpayer for several years prior to World War II had been engaged in a substantial business of building houses for *sale.* He built 45 defense rental units in 1942 under government priorities and *rented* them to war workers *on a month to month basis,* exactly as the partners in our present case rented their homes. He maintained a separate rental office to manage the rental project, as did the partners in the instant case. He was *also* engaged in *selling* houses and as in our present case, no "for sale" signs or advertisements were used in selling the rental units. The Circuit Court held, *as clearly erroneous* the Trial Court's finding

> "that these properties were originally constructed for sale, or, rental, and, that that course of sale was in the regular course of business when they were sold."

The Court also points out another fact (parallel to a fact in this case):

> "By agency regulation, on and after August, 1943, taxpayer *could have sold* 1/3 of the entire rental pro-

> ject, *but he at no time made any effort to secure approval or to sell* any of the units until solicited by returning service men in 1945 * * *".

The Tax Court's statement, we submit, was clearly erroneous. *It is immaterial that the partnership was also in the house selling business.*

This did not prevent it from having relief under I.R.C. Sec. 117 (j).

One of the cases relied upon by the Tax Court in *Farry,* supra, was *Van Tuyl,* supra.

The Respondent has *now acquiesced in both of these cases, Farry,* 1950—1 C.B. 2 and *Van Tuyl,* 1949—2 C.B. 3.

Note also, in *A. Benetti Novelty Co.,* 13 T.C. 1072 at page 1078, referring to the sale of slot machines used in the regular rental operations of the taxpayer, the Tax Court said at page 1078:

> "It seems that the gains in issue were derived from sales of machines which were originally purchased and held for rental purposes only. As indicated in the *Farry* case, supra, *the purpose for which the* property is held is the controlling factor. And *since here the machines at the time of sale were held primarily for rental, the receipts in question are taxable in accordance with Section 117,* as petitioner contends. See also *Carl Marks & Co.,* 12 T.C. 1196 and *E. Everett Van Tuyl,* 12 T.C. 900".

It is evident that the *primary purpose* of the petitioners was to hold these 95 houses *primarily* for the purpose of producing rental income.

The fact that they may have had a *secondary* purpose of sale is immaterial. In *John Graf Co.*, 39 B.T.A. 379, the Board of Tax Appeals was dealing with Section 117 (b) of the Internal Revenue Code which contained the two exclusionary clauses now found in Section 117 (j). In that case the taxpayer manufactured and sold soda water and also sold beer. It also rented out electric water coolers under lease for a term of months and gave the renter an option to buy, in which event the renter was given credit for some portion of the rent already received, on account of the purchase price. The Board held that the coolers sold pursuant to the exercise of the options were not held *primarily* for sale to customers in the ordinary course of its business. At page 386 of its opinion, the Board said:

> "* * * These water coolers, however, were put out by the petitioner in order to sell spring water under a written contract, which very plainly, we think, provides *primarily* (emphasis by the Board) that the contract is one of leasing and not of sale and *that the sale is secondary*" (emphasis by counsel).

Thus, we say, that it is possible to harbor a secondary purpose of sale without interfering with a primary purpose to produce income for rental investment.

2. The requirement of Section 117 (j) is that the property sold has been used in the taxpayers' trade or business.

This is also made very clear by the Circuit Court's decision in *Albright v. U.S.*, (CC 8) 173 F. 2d 339, 344, where the Court said:

> "*Section 117 (j) was intended as a relief measure applicable alike to all taxpayers within its provisions. Leland Hazard v. Commissioner,* 7 T.C. 372. That it

was so intended is clearly expressed in the report of the Committees of the House of Representatives and of the Senate in charge of the bill. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 53-54 (1942-2-Cum. Bull. 372, 415), and S. Rep. No. 1631, 77th Cong., 2d Sess., p. 50 (1942-2 Cum. Bull. 504-545). The section provides an entirely new method of reporting gains and losses on the sale of *non-capital* assets used in the trade or business of the taxpayer. The amendment permits the taxpayer to deduct in full the net loss resulting from transactions within the purview of the section and to report the net gain only to the extent of 50 per cent. *Nothing in the language of the Act indicates an intention on the part of Congress to deny the relief granted by the section to any taxpayer whose transactions meet the prescribed conditions.* * * *"

This case, which relates to the sale of breeder animals, held that the animals in question had been used in the taxpayers' trade or business before their sale and *that this was the only requirement imposed by the statute.*

The Tax Court has agreed with and followed the *Albright* decision in the following cases: *Isaac Emerson,* 12 T.C. 875; *Leslie S. Oberg,* 8 T.C.M. 544, Dec. 17016(M); *Flato,* 14 T.C. 1241, 1250 and *Fields,* 14 T.C. 1202, 1215.

It is significant to note that in *Isaac Emerson,* 12 T.C. 875, at 879, the Tax Court in its opinion also said, referring to the *Albright* case:

"We also agree with that part of the Court's decision wherein it was held that the fact that the hogs from the breeding herd *were customarily conditioned for market before sale does not show that the tax-*

payer has not held them for the purpose of breeding or that they were held primarily for sale to customers in the ordinary course of his trade or business.''

Sec. 117 (j) being a relief section naturally cannot be defeated by imposing any requirements not spelled out by Congress, as is so clearly pointed out in the *Albright* case, supra.

Particular attention is directed to the Tax Court's decision on October 20, 1950 in *Alamo Broadcasting Company, Inc.,* 15 T.C. 534 where, at page 541, the Tax Court significantly says:

> ''The nature of petitioner's loss is governed by our determination that petitioner purchased the diesel with the intent of using it in its new facility. The loss properly falls within the provisions of section 117 (j) as a loss incurred on the sale of property 'used in the trade or business'. We have previously held that 'used in the trade or business' means *'devoted to the trade or business'* and includes property purchased with a view to its future use in the business EVEN THOUGH THIS PURPOSE IS LATER THWARTED BY CIRCUMSTANCES BEYOND THE TAXPAYER'S CONTROL. *Carter-Colton Cigar Co.,* 9 T.C. 219. See also *Wilson Line, Inc.,* 8 T.C. 394; *Kittredge v. Commissioner,* 88 Fed. (2d) 632; *Yellow Cab Co. of Pittsburgh v. Driscoll,* 24 F. Supp. 993; *Independent Brick Co.,* 11 B.T.A. 862.''

Here the purpose of the taxpayer was thwarted in part by the bank's requirement that they sell some of their rental houses but this still does not deprive them of the benefits of Section 117 (j).

3. **A long series of recent Tax Court decisions hold that the number and frequency of sales of property used in the taxpayers' rental business does not cause that property to become property held primarily for sale to customers in the ordinary course of business.**

The effect of the Tax Court's decision in the case at bar is that the number and frequency of the sale of rental units causes that property to become property held primarily for sale to customers in the ordinary course of trade or business and thus brings the property outside the scope of Sec. 117 (j).

This is directly contrary to the decisions involving the sale of rental units, real and personal, hereinafter referred to.

The Tax Court's Opinion (Tr. 77) referring to alleged tests which it says are applied to determine whether property is held primarily for sales to customers in the ordinary course of business and says:

> "* * * One test of whether property is held primarily for investment purposes is lack of continuity of sales, either because of inactivity or infrequency of sales, so that sales which take place have the aspect of isolated transactions. *The test, applied to the facts of these proceedings, fails according to our* understanding of the evidence in these proceedings".

Note also that the Court found (Tr. 73):

> "The sales of the houses in 1944 were continuous and frequent during the three-month period of the sales."

This whole concept of the Tax Court is clearly erroneous in fact and equally contrary to law.

The Respondent in case after case, has *unsuccessfully* contended that sellers of rental properties were not holding their rental property which they sold primarily for rental purposes, but primarily for sale to customers in the ordinary course of business.

But time and time and again, with appalling regularity, in cases similar to this, the Respondent *has been held to be wrong in his position.*

THE NUMBER AND FREQUENCY OF SALES OF RENTAL UNITS HAS NOT PUT THE TAXPAYER IN THE HOUSE SELLING BUSINESS OR CONVERTED THE RENTAL UNITS INTO PROPERTY HELD PRIMARILY FOR THE SALE TO CUSTOMERS IN THE ORDINARY COURSE OF TRADE OR BUSINESS SO AS TO PREVENT HIM FROM HAVING THE BENEFIT OF SEC. 117 (j).

Furthermore, in each of the following cases, the taxpayers *must necessarily have decided to sell their rental units.*

But note that the decision *to sell rental units did not constitute any alleged "abandonment" of the primary purpose to hold for rental and investment* or cause the property to be classed as held primarily for sale to customers.

(a) In *Elgin Bldg. Corporation* (decided February 15, 1949) 8 T.C.M. 114, the number of *rented* units sold was

1944	Elgin	6 units
	Waco	20 units
1945	Elgin	18 units
	An-Lo	3 units
	Waco	26 units

This certainly involved both the element of "frequency" and "continuity" of sales. Under the petitioner's commitments, if a house was once rented, it could not be sold unless the tenant exercised his option to purchase or an outsider bought subject to the tenant's rights. The Tax Court said, page 123:

> "* * * As to all of these properties, we agree that *this circumstance* stamped their primary purpose as rental or income producing housing; and that they were capital assets under Sec. 117 (j). * * *"

This was a case in which the petitioners were *required* to rent the houses. In our instant case the petitioners *voluntarily* held the houses, had a full right to sell the same, the market was active, there was a strong demand for houses, and the possibility of profits high. Surely their situation was no different from the situation of the petitioners in Elgin. And again note that in Elgin the petitioners must have *decided to sell these rental units* and their decision to sell was *not* held to constitute an abandonment of the rental-investment purpose so as to deprive them of relief under Section 117 (j).

The number and frequency of sales of RENTAL units did not deprive the taxpayers of the benefits of Sec. 117 (j) I.R.C.

(b) In *Nelson A. Farry,* 13 T.C. 8, 11 (decided July 6, 1949) the taxpayer did exactly what the taxpayers here did, namely *sold rental units ON THE ADVICE AND COUNSEL OF THEIR BANK.* He sold *19* units in 1944 and *27* units in 1945 *(Observe the number of sales).*

> "By mid 1943 the housing situation especially rental, in Dallas changed materially. The removal of

> the 8th Service Army Command from San Antonio to Dallas, which began in late 1942 was accomplished, bringing in thousands of service personnel. Other war agencies and plants were in operation. The heaviest influx of new Dallas residents had absorbed rental vacancies and people were seeking almost any place to live; if not to rent, then to buy, the scramble to rent or to buy housing, not investment property was well under way in late 1943, it was yet to become more acute in 1944 and 1945, when housing demands forced prices to new peaks. *Under these conditions and in view of rent control, when petitioner counselled with his banker, the advisability of liquidating some of his rental properties was suggested.* It was pointed out to petitioner by his banker that interest on the notes which he could take in the sale of these rental properties would yield more than rent from the property. *PETITIONER CONCURRED IN THIS VIEW.*"

Note that "*Petitioner concurred in this view*". There can be no doubt but that the petitioner *MADE A DECISION* to sell SOME of his rental property, which was exactly what was done by the petitioners in the instant case. At page 13, in the course of its opinion, the Court in the *Farry* case says:

> "* * * However, it seems to us that the petitioner has proved by overwhelming evidence that he purchased and held these rental properties primarily for investment purposes. *The fact that in the taxable years he received satisfactory offers for some of them and sold them does not establish that he was holding them 'primarily for sale to customers in the ordinary course of his business'.* The evidence shows that he was holding them for investment purposes and not for sale as a dealer in real estate."

(c) *Julia Robertson,* 8 T.C.M. 870 (decided September 29, 1949). In 1944 the taxpayer sold 4 rental units and in 1945 5 were traded and 10 were sold. *(Thus, in 1945, 15 units were disposed of; in our instant case 14 rental units were sold in 1944.)* Referring to the houses having been built for rental, the Court said (p. 872):

> "* * * Furthermore, petitioner's testimony (i.e. that the houses were acquired for rental) that such was his purpose in acquiring the properties is *corroborated by the use to which the properties were devoted in the taxable years. In those years they were devoted primarily to rental and not to sales.* * * *"

(In our instant case, the 95 units were built for rental and were rented continuously for 17 months to 156 tenants before a single sale was made.)

(d) *A. Benetti Novelty Co.,* (decided December 22, 1949) 13 T.C. 1072. The petitioner's principal source of income was from the *rental* of slot machines, coin operated phonographs, etc. During the war the Armed Services desired to purchase machines for canteens, officers' clubs, etc. *Some machines were purchasd for resale.* The principal question was as to the sale of the machines from the taxpayer's *rental* business. The Court said (p. 1074):

> "During the taxable year petitioners *DEEMED IT ADVANTAGEOUS* to retain and use in its business the newest and most attractive machines so purchased and *TO SELL* TO SERVICE CLUBS THE OLDEST MACHINES *USED BY IT IN ITS REGULAR OPERATIONS.* Machines used in petitioner's operations were regularly moved from the place of business where located to petitioner's service shop where they were serviced, repaired and if necessary rehabilitated. * * *"

What we ask to be noted is that the Court in its opinion declares that the petitioner *DEEMED IT ADVANTAGEOUS* TO SELL TO SERVICE CLUBS THE OLDEST MACHINES PREVIOUSLY USED BY IT IN ITS REGULAR OPERATIONS. Therefore, the Petitioner must have made a DETERMINATION OR DECISION to sell old machines used in its regular rental business. The significant thing to note is that the fact that that decision made by the taxpayer which is little different from the decision made in this case, *did not amount to an "abandonment" of the purpose of holding machines primarily for the produtcion of rental income. And, this did not prevent the operation of Sec. 117 (j).* At page 1078, the Tax Court says:

> "It will be noted in the findings of fact here that the major portion of the profits involved was derived from the sale of machines *held for rental purposes several years prior to sale.* During 1942, 1943 and 1944 it purchased more machines than ordinarily and it is stipulated that during the taxable years involved petitioner *'deemed it advantageous* to retain and use in its business the newest and most attractive machines so purchased * * * and *to sell to service clubs the oldest machines PREVIOUSLY used* * * * in its regular operations'. ITS 'REGULAR OPERATIONS', of course, CONSISTED OF RENTING THOSE MACHINES. It thus seems that the gains in issue were delivered from sales of machines *that were originally purchased and held for rental purposes only.* As indicated in the *Farry* case, supra, (13 T.C. 8) the purpose for which the property is held *is the controlling factor,* and, since here the machines *at the time of sale* were held primarily for rental, the receipts in question are taxable in accordance with Section 117 as petitioner contends. * * *"

The machines sold were thus ones *previously* used in the rental business. It appears that *93 units were sold in 1943, 135 in 1944 and 27 in 1945* (Opinion, p. 1075-6) *but this number and frequency of sales did not mean that the seller was holding the machines it decided to sell, primarily for sale* so as to deprive it of the benefit of Sec. 117 (j).

(e) *Claude M. Ferguson,* (March 21, 1950) 9 T.C.M. 243. This is a very significant decision. Here the taxpayer sold *rental* properties and the *Commissioner contended that the number and frequency of sales put the taxpayer in the business of selling homes.* The Court in its opinion refers to the *Farley* case, 7 T.C. 198:

> "* * * During the taxable year the taxpayer sold some lots. He made no efforts to sell, but accepted such offers as were made. He did not advertise the property for sale, hired no agents, erected no signs, did not list the property, or construct any improvements to facilitate its sale for residential purposes. Noting that the frequent and continuous character of the sales resulted *notwithstanding the taxpayer's passivity rather than from any business activity on* his part, *we refused to apply the 'frequency and continuity' test, and held that the property of the taxpayer was not held primarily for sale to customers* in the ordinary course of his trade or business and that the profit derived from the sales in question was taxable as a long-term capital gain and not as ordinary income."

Now observe the Court's decision:

> "* * * We are convinced from the evidence that he purchased such property from 1936 to and including

the taxable years as an investment so that he might derive profit from rentals. *It was not purchased or held primarily for sale,* and such sales as were made during the taxable years of this residential property resulted from unsolicited offers to purchase made by tenants and others or *from pressure put on petitioner during the years 1945 or 1946 by banks,* who had loaned him money to finance purchases, to have him repay a substantial portion of the money loaned. *Sales made under such circumstances do not establish that petitioner was holding this residential property 'primarily for sale to customers in the ordinary course of his trade or business.'* We have made a finding that this residential property was not so held, and it follows that any gains realized by petitioner from the sale of the properties listed in our findings which were held for more than six months are taxable as capital gain and not as ordinary income. Any gain realized from residential property sold which was not held for more than six months is taxable as ordinary income. See *Nelson A. Farry,* 13 T.C. 8 (Dec. 17,079)."

But, *the number and frequency of sales again did not prevent the operation of Sec. 117 (j).*

And note also what the Court said about sales resulting *from the pressure put upon the taxpayer by banks.*

(f) *Roy L. Self,* (May 26, 1950) 9 T.C.M. 421. Here all of the houses were rented to tenants from the time of completion until the time of sale. *Thirteen (13) such rental houses (1 unit less than the number sold by petitioners herein in 1944) were sold.* There was a very active demand for houses when these houses were completed,— *"a seller's market"* prevailed and *all of the houses could*

have been sold on completion, just as McGah & O'Shea could have sold their 95 rental houses on completion. The taxpayer, Self, must necessarily have *decided* to sell his 13 houses, but neither that fact, nor the fact that *13* houses were sold, was held, as a matter of law, to constitute an "abandonment" of the purpose to hold primarily for rental as to deprive him of the benefits of Sec. 117 (j) I.R.C.

(g) *Mary Alice Browning,* 9 T.C.M. 1061, a memorandum decision of the Tax Court, decided November 27, 1950. This case involved the sale of rented equipment. During the two fiscal years involved (1944 and 1945), the taxpayer sold *24 and 32 pieces of rental equipment.* (*Note the number of sales,—56 items* sold.) There, as here, the Respondent contended that such sales were of property held primarily for sale to customers in the ordinary course of business. *The Tax Court held for the taxpayer and allowed the benefit of Sec. 117 (j).*

(h) *Delsing v. U. S.* (C.C. 5) January 5, 1951 (official citation not yet available), reversing the United States District Court for the Northern District of Texas, cited by the Tax Court in its opinion (Tr. 80). Here, under priorities, the taxpayers constructed 45 defense rental units which were rented to war workers *on a monthly basis,* exactly as these petitioners rented their houses. The taxpayer Delsing made his *first sale in August, 1945 and sold the remainder in October and December, 1945.* (Observe that 12½ duplex units were sold within three months.) *The Court said that the disparity between income from sales and income from rentals was not controlling* and held

> "We find *no permissible basis* for a determination that the sales of the *originally constructed defense rental housing* units constituted a disposition of 'property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business' so as to render the profits taxable as ordinary income."

The Court further held that it was immaterial that for several years prior to the war the taxpayer had been engaged in a substantial business of constructing homes for sale.

This long line of cases, recently decided, establish clearly, we think, that the criteria used by the Tax Court in our instant case are contrary to Sec. 117 (j) as that section has been thus construed.

The number and frequency of sale of rental units does not deprive the taxpayer of the benefit of Sec. 117 (j) nor does his decision to sell some or all of his rental units constitute any abandonment of his former rental purpose nor cause the property to be classified as property held primarily for sale to customers in the ordinary course of trade or business.

In its opinion (Tr. 80) the Tax Court says that it thinks that the reasonable inference to be drawn from the evidence is that the partnership was in the business of selling houses in 1944 within the meaning of I.R.C. Sections 117 (a) and (j) citing, *inter alia, Delsing v. U. S.* (D.C. No. Dist. Texas), *Ehrman v. Comm.* (CC 9) 120 Fed. 607 and *McFadden,* 2 T.C. 395.

The District Court's decision in *Delsing v. U. S.* has been reversed by the Circuit Court.

In the *Ehrman* case, supra, this Court held that the facts necessary to create a trade or business within the meaning of the Revenue Act *"revolve largely around the frequency or continuity of the transactions* claimed to result in the 'business status'."

Well and good. Consider the *stipulated facts* in this case (Tr. 150) that *"from March 15, 1943 until August 14, 1944, said 95 houses were rented to 156 different tenants".* IN OTHER WORDS, IN NEARLY 17 MONTHS THERE WERE 156 RENTAL TRANSACTIONS INVOLVING 95 PIECES OF PROPERTY.

If *frequency and continuity* determine business status, it is respectfully submitted that the 156 rental transactions involving 95 rental units *clearly demonstrates that the partnership was in the HOUSE RENTAL business.*

The same is true with respect to the tests shown in *McFadden,* 2 T.C. 395, 405.

The other cases referred to in the Tax Court's Opinion (Tr. 80) are not reported in Federal Supplement and since we do not have access to them, we cannot comment thereon.

Carl Marks & Co., 12 T.C. 1196, is the converse of our case. There petitioner, a dealer in foreign securities, *transferred* all of its domestic securities and certain of its foreign securities out of its *inventory* into an *investment* account on December 29, 1941. It was held that as a result of the *transfer,* the securities took on the character of *capital assets* and hence their status as such at the time of sale determined the taxability of the gain as a long term capital gain. The Court said (p. 1202):

> "* * * Certainly it cannot be argued that securities one acquired for resale to customers must forever retain their dealer status, when in fact there has been a *conversion* of those securities from a *dealer* to an *investment* account. *E. Everett Van Tuyl,* 12 T.C. 900. The crucial factor to consider in determining the character of the securities involved is the *purpose* for which they were held during the period in question and in this case we believe the facts show that those securities were held for investment purposes after December 31, 1941."

Be it noted, however, that in that case, there was a *conversion, a voluntary and express change of purpose* (p. 1202):

> "* * * Petitioner took detailed and extensive steps, as shown in our findings, to segregate the handling of those securities *transferred* to the investment account, both *physically* and on its books of account. * * *"

BUT IN OUR PRESENT CASE THERE IS NO EVIDENCE OF ANY SUCH EXPRESS *CHANGE OF PURPOSE,* OR OF *ABANDONMENT* OF PURPOSE, TO HOLD PRIMARILY FOR THE PRODUCTION OF RENTAL INCOME. The evidence shows only that their banker requested or demanded that they sell *some (NOT ALL)* of their rental units. The evidence shows only what they *did;* they sold units *as they became vacant* which is but another way of saying that THEY WERE USED IN THE RENTAL BUSINESS *(which continues until today with 35 units)* UNTIL THE MOMENT OF SALE. There never was a "*conversion*" as in *Carl Marks & Co.*

When one stops to consider Sec. 117 (j) in relation to the *sale* of real property used in the trade or business and held primarily for the production of rental income and not held primarily for sale, it is quite obvious that the Section would be *meaningless,* if construed to mean that the decision of an owner to sell, and his sale, of such property would take the owner out of the rental business and put him in the house selling business and automatically classify the property used in the rental business as property held primarily for sale to customers in the ordinary course of trade or business and thus preclude relief under the section.

4. The Tax Court erroneously construed Section 117 (j) by its holding that unless the taxpayer has a fixed purpose of staying in the rental business for a "long period of time" he cannot be deemed to be in that business so as to enjoy the benefit of the section when he sells his rental units.

In its opinion the Tax Court says (Tr. 78) that:

> "* * * And the partners, themselves, had *no fixed purpose in 1944 of renting the properties for a long period of time,* or of holding them for investment purposes, according to the testimony of one of the partners. *How long they would 'be in the business' was a matter of conjecture to them.*"

Here we think the Tax Court has utterly misconstrued the meaning and effect of I.R.C. 117 (j).

But before we examine the law, let us first look at the proof in the record which shows that the *actual intention* of the partners, as shown by their testimony, was quite different from what the Tax Court's Opinion says was their intention.

The opinion also states (Tr. 76) that "O'Shea testified that he and his partner did not know, at the time they applied for priorities ratings, in 1942, how long San Leandro would be in *'the business'* and that it was impossible to guess * * *."

What Mr. O'Shea *actually said* was (Tr. 129):

> "At the time we decided to embark on that *rental* project, Mr. Nyquist, it would appear that we wouldn't know how long we would be in *the business;* because, why *we would have to rent them for the duration of the war.* We didn't know the length of time we would be in *the business.* It was impossible to guess at that particular time."

Also note Mr. O'Shea's statement (Tr. 131):

> "We expected to *rent* them for an indefinite period."

We think that a fair consideration of the *facts* requires the conclusion that *"the business"* referred to by the witness was the *rental business* which it was contemplated would run *"for the duration of the war,"*—how long *that* would be, naturally the witness couldn't guess.

We think that the Tax Court's statement thus goes far beyond the proof in the record.

If, as in our present case, parties *are actually in the house rental business* (as these partners were for over 17 months before they sold the first house at the bank's suggestion), it is wholly immaterial that they harbored the *secondary* thought that *ultimately* they would or *might* sell the rental uses.

The statute (Sec. 117 (j) (2)) declares that if during the taxable year the gains upon sales *"of property used in the*

trade or business'' for over 6 months exceed the losses from the sale of such business, the gains shall be considered gains from the sale of *capital assets* held for more than 6 months.

Despite the favorable opportunity to sell, the petitioners *rented the 95 units continuously for 17 months before a single sale was made and then sold under pressure,—only because their banker demanded it.* WHAT THEY DID IS THE STRONGEST POSSIBLE CORROBORATION OF THE FACT THAT THEY MAINTAINED THEIR ORIGINAL PURPOSE TO HOLD THE 95 HOUSES PRIMARILY FOR THE PRODUCTION OF RENTAL INCOME.

There could have been no clearer proof than this of their intention to carry on *the house rental business. Hazard,* 7 T.C. 372, 375; *Noble,* 7 T.C. 960, 964; *Fackler,* 45 B.T.A. 708, affd. 133 F. (2d) 509; *Jephson,* 37 B.T.A. 1117; *Campbell,* 5 T.C. 272; *Kimbell,* 41 B.T.A. 940; *Vosburgh,* 23 B.T.A. 780.

This is *not* a case where property was acquired and held primarily for sale and was rented only while awaiting sale as in *Schultz,* 44 B.T.A. 146, *Black,* 45 B.T.A. 204 and *Morely,* 8 T.C. 904, cited by the Court.

The fact that the taxpayer engaged in good faith, as these partners were, in the house rental business harbor an *ultimate* or *secondary* purpose of selling the houses one day, does not deprive them of the benefits of Sec. 117 (j).

The very use of the word *''primarily''* in the statute connotes the possibility of there being a *secondary* pur-

pose and it is the *primary* and *not* the *secondary* purpose that controls.

The correctness of this view will also appear in the next subdivision of this Brief.

5. **The Tax Court erroneously holds that the primary purpose to hold the houses for the production of rental income is negatived by the fact that the partners lacked substantial capital of their own and borrowed substantially all of the capital required for the venture.**

In its opinion (Tr. 77) the Tax Court says:

> "* * * The petitioners assert that San Leandro, in the taxable year, was engaged in an investment operation. But the record shows that San Leandro lacked any substantial capital of its own *and it is a fact that it had borrowed practically all of the capital required to purchase the lots and build the houses.* The evidence shows, also, that the annual net income from rental receipts was small in view of San Leandro's indebtedness to the Bank. *The situation was such as we construe the evidence in the record before us, that realization of any substantial gain depended upon making sales of the houses.* * * *"

This construction of the evidence and concept of the law is both *clearly erroneous* and *completely unrealistic.*

It is clear from the record that 100% F.H.A. 20-year loans *were* available; that the partnership had priorities to build 169 *rental* homes; that they were granted 100% F.H.A. loans to build such *rental* homes.

Yet the Tax Court's opinion (Tr. 75) further says:

> "* * * An *obvious question* is how San Leandro expected to pay the loans obtained to build the houses

> and how long it would take to work out the project from the viewpoint of the financing which was adopted. *San Leandro was created with a very small amount of working capital.* * * *"

It can truthfully be said that the *answer* is obvious, but that the *question* is not.

The complete unreality of the Tax Court's viewpoint is well illustrated by a consideration of some of the *stipulated facts,* particularly the rental income and expense figures shown in Petitioner's Ex. 3 (Tr. 167):

Let us look at the depreciation figures for 1948 and 1949, *years in which admittedly the partnership was still renting 35 of the 95 houses.*

The depreciation figures for each of these two years were identical, viz.—$7,041.34. Divide this by 35 houses gives *$201.18 tax free depreciation dollars per year per house.*

Thus, in the 20 year period for which such loans are authorized (U.S.C.A. Title 12, Sec. 1709 (b) (3)) the total amount of tax free depreciation dollars would equal $4,023.60 which is slightly in excess of the $4,000.00 borrowed for each house so that THE TAX FREE DEPRECIATION DOLLARS ALONE WOULD PAY OFF THE WHOLE LOAN IN 20 YEARS.

That is obviously why the partners testified that they considered the rental deal a good investment.

The partners fully realized that it was a *good investment* to build 169 rental homes on 100% F.H.A. loans.

Thus, when Mr. O'Shea was asked if at the time the application for preference ratings were made, either he or McGah contemplated the *sale* of any of the 169 houses, he testified (Tr. 129):

> "A. *No, we did not.* At the time we entered into that application, *it was our full intention to embark upon a rental project,* because it looked as if it would be a very advantageous one to us financially, *inasmuch as we could secure 100% loans from the Bank through the F.H.A. insurance and by so doing we could receive 100% on no investment at all.* So it seemed to be a prudent thing for us to embark on it."

Also (Tr. pp. 128-129):

> "Q. What was the intention of the partners, Mr. McGah, with respect to the unsold houses, *the 95 remaining houses?*
>
> "A. It was our intention to retain those houses as a rental investment, *because it was evident that it was going to provide a good one from a financial standpoint.*"

The witness McGah also testified (Tr. 124):

> "Q. In renting these, in retaining and renting these 95 homes here referred to, Mr. McGah, was it your intention to hold them for rental investment?
>
> "A. Both".

Further, McGah testified as to the adequacy of a $50.00 per month rental (Tr. 124):

> "Q. (By Mr. Nyquist) Were you of the opinion that any of them could be profitably rented at $50.00 per month?
>
> "A. *I sure was*".

We respectfully submit that the Tax Court's determination that the fact that the taxpayers utilized 100% F.H.A. loans instead of their own capital shows a lack of purpose to produce income for investment purposes is *clearly erroneous* and that its analysis of the financial aspects of the case is utterly unrealistic.

It is respectfully submitted that the Tax Court's Opinion is contrary to law.

First, it has inferred an *abandonment* of the purpose to hold the 95 houses primarily for the production of rental income, contrary to law in that *abandonment* was not the inference *exclusively* required as a reasonable conclusion from the facts proven.

Second, it has construed Sec. 117(j) in a manner contrary to the declared purposes of the section and in a manner that fails to afford the relief which was intended by that section, as shown by the *Albright* case.

Third, it contrary to a long line of cases which hold that the fact that a taxpayer who sells property used in his *rental* business is also engaged in the business of selling the same kind of property does not deprive him of relief under Section 117(j).

Fourth, the long list of cases shows conclusively that the number and frequency of sales of property used in the taxpayers *rental* business does not put the seller in the property *selling* business or convert the property so used in the rental business to property held primarily for sale to customers in the ordinary course of trade or business.

The impressive list of decisions which we have cited shows that even though the taxpayer, engaged in the business of renting real and personal property, *decides to sell some of the property used in his rental business* and *then makes numerous sales thereof,* that neither his decision to sell nor the number or frequency of his sales deprives him of the relief afforded by Section 117(j) and does not put him in the house selling business or convert the rental property into property held primarily for sale to customers.

III.

THE TAX COURT ERRONEOUSLY CONCLUDED THAT "THE CENTRAL BANK WAS NOT DISPOSED TO CARRY SAN LEANDRO FOR ANY EXTENDED PERIOD OF TIME, ACCORDING TO THE RECORD BEFORE US", WHEREAS THE TAX COURT'S VERY OWN FINDING THAT THE BANK'S REQUIREMENT FOR FASTER LIQUIDATION RELATED TO ADDITIONAL BORROWING, RATHER THAN TO THE BORROWING RELATED TO THE 95 RENTAL HOMES WHICH THE TAX COURT FOUND WERE FINANCED AS 100% F.H.A. LOANS, NONE OF WHICH WERE SHOWN TO BE IN DEFAULT.

The above quoted statement from the Tax Court's opinion appears at Tr. 76:

> "* * * The Central Bank was *not disposed to carry San Leandro for any extended period of time,* according to the record before us. About one year after the project was completed, *it demanded faster liquidation of the original loan or loans.* * * *"

This statement in the opinion *is absolutely contrary to the stipulated facts* (Tr. 153).

The stipulated fact is that about the middle of 1944 the partners discussed with the bank

"the possibility of securing MORE loans."

As a result of their desire to secure *more* working capital it was suggested that they liquidate *some* of their rental properties

> "in order to reduce their bank liabilities AND *as a means of* PROVIDING THEMSELVES *with additional working capital, suggesting* IN ADDITION *that they should take advantage of the then existing market for houses.*"

Thus, the *fact* is vastly different from the Tax Court's *opinion,* as quoted above.

It is *not* a fact that the Bank was "not disposed to carry San Leandro for any extended period of time" and that it therefore "demanded a faster liquidation of the original loan or loans."

What happened was that the partners wanted *more* loans, whereupon and in connection with the desire for *more* loans, the bank suggested that it sell *some* of its rental properties *as a means of providing themselves with working capital* AND in order to take advantage of the then market for homes.

In other words, the partners were told that if they wanted *more* capital, they had better provide *some* of it themselves by selling *some* of their rental homes.

But there is no evidence that *otherwise* the bank was not disposed to carry the original loan.

SUMMARY AND CONCLUSION.

The Tax Court's decision here under review is erroneous and completely unrealistic, both as to its *findings of fact* and its *conclusions of law.*

There can't be any question but that the partnership *was engaged in the house rental business* with real property held over 6 months.

The partnership was *formed* for that purpose, as original associate withdrew from the project *because* it *was* a *rental* project, priorities were obtained *for* a *rental* project, the 74 houses sold without being rented were sold for a reason fully explained by uncontradicted evidence (viz. the promised substitution of $50.00 per month rental priorities for the $39.99 per month units failed to materialize which was the *only* reason why the units were sold), the 95 remaining units were *rented* continuously to 156 defense workers for a period of 17 months before a single unit was sold, the partners, had they wanted to, could have sold the 95 units instead of renting them, there was a very active demand for houses by sellers during the entire period that they were being rented, the partnership sold houses because of the pressure exerted by the bank and sold 14 rental houses in 1944, (the tax year in question) *only as houses became vacant,* without advertising the houses for sale or displaying "for sale" signs, and at the end of the fiscal year, 1944 were *still renting* 81 of the houses. All rental operations were carried on by the partnership from an office which it maintained for that purpose.

The Tax Court made a finding that shortly before August 1, 1944, the partners *"abandoned"* their purpose

of holding these 95 homes primarily for the production of rental income.

Necessarily, this admits and proves that the partnership *had* the purpose of holding the 95 homes primarily for the purpose of producing rental income. The partners could not very well have *abandoned* a purpose which they did not have.

Thus, we say, there can be no doubt but that the partners *were in the house rental business with the 95 houses from the very time that the houses were completed, about March 15, 1943.*

At the end of its several fiscal years from 1944 to and including 1949 and on the very date of trial, the partnership was *still* in the house rental business *renting houses,* as follows:

End of Fiscal Year	Number of Houses Rented
1944	81
1945	50
1946	38
1947	35
1948	35
1949	35

With the market in 1944 described as "terrific",—you could sell 50 houses for every one you had,—houses could be sold without advertising,—it is completely unrealistic, in the light of the foregoing figures, even to suggest that the partners *ever* gave up their purpose to hold houses primarily for the production of rental income.

To be sure, *they sold some of the houses that were being used in the house rental business,*—sold them as

they became vacant and thus were entitled to the benefit of the relief provisions of I.R.C. Sec. 117(j).

The Tax Court's opinion again quite unrealistically questions how the partnership expected to repay these 100% F.H.A. loans with which it paid for the houses and the building sites.

It is clearly evident from Petitioners' Exhibit 3 (Tr. 167) that these were installment loans on a 20-year basis.

This is shown by the depreciation figures for the years 1948 and 1949, when there were no sales and when 35 houses were rented.

In each year, total depreciation was $7,041.34 which divided by 35 houses gives annual depreciation of $201.80 per house.

Multiply this figure by 20 years and you have just slightly in excess of $4,000.00,—*enough to pay off the loan in 20 years with tax free depreciation dollars,* assuming that the partners had no other means of payment, which assumption, in light of the evidence is *an assumption contrary to fact.*

The Tax Court's concept of this case on the *factual* side is thus demonstrably unrealistic and contrary to the evidence and hence *clearly erroneous.*

On the *legal* side, the opinion is also *clearly erroneous.*

The finding of fact that the partners "abandoned" their purpose of holding the 95 houses primarily for the production of rental income (aside from being false in fact) *is based on an inference made contrary to law,* as well as *contrary to the fact.*

The evidence shows that when subjected to pressure from the bank to sell *some* of the rental units (*not* "all" of them) the partners sold *some* houses as they became vacant.

There is no direct evidence in the record of their intention.

Their purposes and intentions are thus a matter of the *inference* to be drawn from the *facts* showing what they *did.*

The most that legitimately can be *inferred* from what they *did* is that *they decided to sell some of their 95 rental houses as they became vacant.*

The Tax Court, however, inferred that just prior to August 1, 1944, *they abandoned their purpose of holding the 95 rental houses primarily for the production of rental income.*

This was an inference *contrary to law.* We have cited the authorities which show that this inference was improper *because it was not the ONLY inference that could be drawn from the facts.*

It was equally proper to infer that *they intended to sell some of their rental units as they became vacant.*

The error of the Tax Court's inference of an abandonment of purpose is thus clearly evident.

But, adding error to error, the Tax Court also finds that after August 1, 1944, the partners held the 95 houses primarily for the purpose of sale to their customers in the ordinary course of their trade or business.

This finding is also based on an improper inference from the facts and an erroneous conclusion of law.

Several things seem to have impelled the Tax Court's erroneous conclusion in this respect:

First, the Tax Court points out that the partners were *also* engaged in the business of *selling* houses. *That the partners were also engaged in the business of selling houses is wholly immaterial, so far as their right to the benefits of Sec. 117 (j) on the sale of rental units is concerned.* This we have shown by an abundant citation of authority.

Second, the Tax Court relies on the number and frequency of sales (14 in 1944) as showing that the partners were in the house *selling* business. *That the number of rental unit sales made deprived them of the benefits of Sec. 117 (j) is a conclusion contrary to law,* as shown by the uniform allowance by the Tax Court of Sec. 117 (j) benefits in seven cases and by the Circuit Court in one decision, of such benefits in cases in which the sales of rental units were both numerous and frequent.

To disallow the benefits of Sec. 117 (j) upon the sale of real property used in trade or business and held for over 6 months because of the number and frequency of sales *is to completely nullify the purpose and intent of Sec. 117 (j).*

If a man who used an office building in his trade or business of operating an office building held for over six months, for the production of rental income, sells it for $500,000.00 and realizes a gain of $100,000.00, there is no

number and frequency of sales to deprive him of the benefit of Sec. 117 (j).

If a man, who has been renting 100 dwellings continuously for over 6 months for the primary purpose of producing rental income,—and who is not holding them primarily for sale to customers, sells them as they became vacant, for $500,000.00 and realizes a gain of $100,000.00, then, because he had 100 units to sell and sold them one by one, according to the Tax Court, he is *deprived* of the benefit of Sec. 117 (j) even though he used each house in his rental business right up to the very moment of its sale.

That is *not* what the Congress *said* and it is *not* what the Congress *meant* as is clearly shown in the many cases cited wherein the number and frequency of sales *did not* deprive the taxpayer of Sec. 117 (j) benefits. See *Albright v. U. S.* (CC 8) 173 F.2d 339, 344).

Thus we say and respectfully submit that the Tax Court's challenged findings and opinion are *clearly erroneous* and *contrary to law* and that the decision should be reversed.

Dated, Oakland, California,
March 2, 1951.

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